CONNECTICUT
VOICES
FOR CHILDREN

# Testimony Regarding Needed Reforms to Statutory Spending Cap Definitions and the Budget Reserve Fund.

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Committee on Appropriations
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Senator Harp, Representative Walker and members of the Appropriations Committee:

I am testifying today on behalf of Connecticut Voices for Children, an independent child advocacy organization is a member of the State Fiscal Analysis Initiative, a nationwide network of organizations that advocate responsible state fiscal policy with a particular focus on the needs of middle- and lower-income families. I am a Senior Policy Fellow at Connecticut Voices, concentrating on state fiscal policy.

Today I submit testimony in two parts, the first **regarding potentially helpful reforms to spending cap definitions**, and the second **regarding the state Budget Reserve Fund**.

As the Connecticut economy recovers from the last recession, current statutorily-defined limits on expenditure growth pose a serious problem: Connecticut's spending cap will likely restrict the state's ability to restore needed services that were cut in the downturn, despite the resources to do so as the economy recovers. Spending cap definitions constrain budget growth at precisely the time when the budget can grow and allow greater growth precisely at the time when revenues are depleted. This mis-match, coupled with the use of *actual* spending as the budget base, rather than *allowable* spending under the cap in a downturn, means that state spending as a share of Connecticut's economy ratchets down with each economic downturn. Since 1992, a year after the spending cap definitions were implemented, state general expenditures in Connecticut are down from 10.7% of total personal income to 10.0%[*] of personal income in 2008, despite the fact that the cost of delivering government services such as public education and healthcare have increased by triple-digit percentages.[1] Yet public investment (in education, infrastructure and the like) is key to economic growth and should grow with Connecticut's economy. Growth allowed under the spending cap in the next several years while the state recovers from the worst recession since the Great Depression will be the lowest since the cap's inception.

For this reason and others,[2] Connecticut Voices for Children argues that Connecticut's statutory spending cap is flawed in three primary ways:

**(1)** The growth allowed by the cap bears little relation to actual growth in the state's economy because it is based on averages that do not reflect full economic cycles (See Figure 1, at bottom of testimony) and understates Connecticut's economic capacity since the measure of personal income used excludes capital gains income. In addition, the base

[*] If Connecticut's budget in 2008 were 10.7% of income, rather than 10.0% of income, it would have been $1.4 billion dollars larger.

of the cap is artificially low because spending that exceeds the cap (as approved by the Governor and General Assembly) is not consistently added to the budget base.

**(2)** The cap has created a disincentive for Connecticut to pursue federal funds.

**(3)** The cap has resulted in reduced accountability because the state has employed certain budgetary practices to avoid the cap – such as borrowing for operating costs, revenue intercepts and tax credits and exemptions - that remove significant portions of the state budget from public and legislative oversight.

To address these concerns, we propose that the General Assembly:

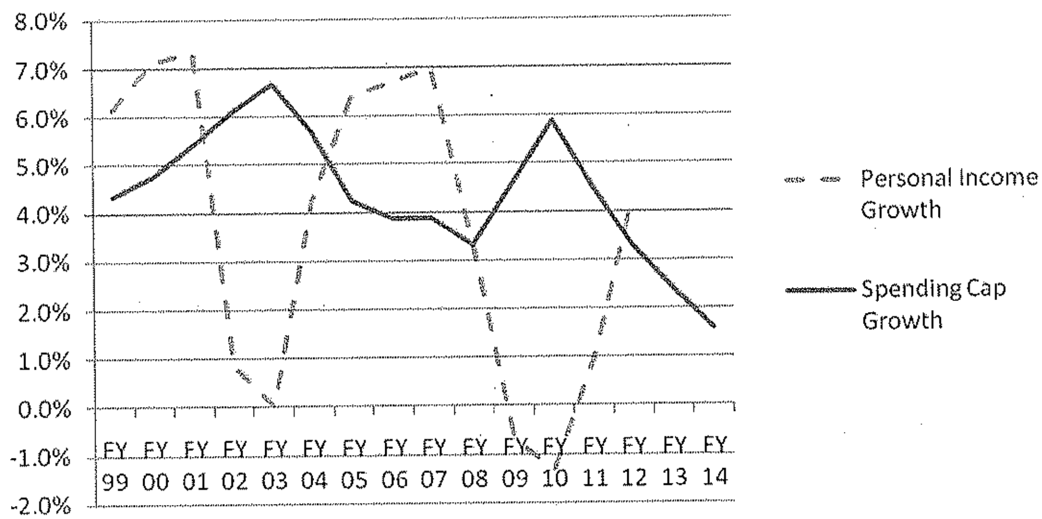
**A.** Redefine the term "personal income growth," as is currently used to determine allowable general expenditure growth from year to year, to mean the average income growth over the preceding ten years, rather than the preceding five years. A ten year look-back will better fit the median length of an economic cycle, and reduce the volatility produced by a shorter look-back period.

**B.** Amend the statutory definition of "personal income" to include capital gains income and adjust personal income statistics accordingly when calculating growth in personal income. Economists from the Federal Reserve Bank of Boston have developed a method of adjusting income growth statistics from the Bureau of Economic Analysis, which does not include capital gains, for the growth in capital gains.[3]

**C.** In years when state unemployment exceeds the state's ten year average rate, permit the budget base to be the appropriated spending allowed by the spending cap in the previous year rather than the amount actually appropriated in the previous year.

**D.** Permit the state to take advantage of federal funds which support needed services by not counting as "general budget expenditures" the first year of any new federal funds received by the state that are appropriated by the General Assembly, and including the funds in the budget base for purposes of determining the spending cap for the ensuing fiscal year.

Figure 1. Growth in the spending cap in Connecticut is inversely timed to fluctuations in personal income growth




The figure above shows how current spending cap definitions that use a five-year average of income growth to determine spending cap growth have caused spending caps to rise during periods when income growth—and therefore revenue growth—craters but to fall during periods when income growth is strong. The result is that when Connecticut has no revenue to spend its spending cap rises, but when revenues recover the spending cap is lower. Negative income growth over the last recession makes it so Fiscal Year 2014 is projected to be the *first* year that inflation, not personal income growth, will determine allowable spending cap growth (1.6% for PI v. 2.8% for inflation). This is a dramatic limitation that does not accurately measure the changes in the cost of providing services such as health care and education.

**Connecticut's Budget Reserve Fund must be strengthened, but HB6586 may constrain the state's ability to restore services cut over the recession as revenues recover.**

The past recession has demonstrated that Connecticut's "Rainy Day" account was inadequate to fully compensate for lost revenue, ultimately forcing the state to rely upon spending cuts and tax increases to close budget deficits. Even with a reserve fund at 80% of being "fully funded" in August of 2008, Connecticut quickly went though its reserves in FY2010 and FY2011 and still required significant borrowing and spending reductions in order to close the massive deficits that resulted from the recession.[4] Connecticut Voices for Children advocates raising the full-funding target of 10% up to 15% or higher so that the state is better prepared for future recessions.

Another bill, HB 6586, would automatically commit a portion of state taxes collected on unearned income to the Rainy Day account, payment of outstanding debt, and extra contributions to public pension funds. The tax revenue would be committed in a 50-25-25 ratio. Putting aside a part of capital gains, interest, and dividends income to improve the state's fiscal position is a good concept as it would use a particularly volatile type of income to replenish the Budget Reserve Fund during good economic times. However, as designed, HB 6586 has the potential to constrain state spending as it recovers. HB 6586 would commit *all* growth in capital gains after FY2013 to the above purposes. In Connecticut, where unearned income has equaled up to one fifth of total income[5], this is potentially a very large component of overall revenue growth. Instead, the General Assembly should consider committing only a portion of capital gains growth to ensure greater flexibility to restore services that were reduced over the recession and to fund strategic long-term investments.

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1 "State general expenditures" includes all direct expenditures as well as intergovernmental expenditures, such as grants to towns. State expenditures data from the U.S. Census of Governments. http://www.census.gov/govs/state/historical_data_2008.html. Connecticut total personal income data from the U.S. Bureau of Economic Analysis, Regional Economic Accounts. http://www.bea.gov/regional/spi/default.cfm?selTable=summary.
The U.S. Bureau of Labor Statistics consumer price indices show that Medical Care has increased by 100% between 1991 and 2008 and Education has increased by 131% between 1993 and 2008 (1993 is the earliest education index available).

2 See S. Geballe, *Coping with the Cap: A Primer on Connecticut's State Spending Cap and Its Impacts* (Connecticut Voices for Children, April 2007), available at: http://ctkidslink.org/publications/bud07spendingcap.pdf.

3 Popov and Weiner, "Assessing Alternative Measures of State Income," Federal Reserve Bank of Boston, July 30, 2008, available at http://www.bos.frb.org/economic/neppc/memos/2008/weingerpopov073008.pdf

4 The Budget Reserve Fund reached 80% funding in FY2008. Connecticut State Budget, 2007-2008 revisions. Office of Fiscal Analysis. p. 7 http://www.cga.ct.gov/ofa/Documents/year/BB/2009BB-20080800_FY%202009%20Connecticut%20Budget%20Revisions.pdf
Practically all of the $1381.7 million in SRF was depleted to reduce the deficit in FY2010, while $103.2 million was used to reduce the deficit in FY2011. Connecticut State Budget, 2010-2011 Revisions. Office of Fiscal Analysis. p.18

5 In 2007, 20.3% of aggregate income in Connecticut was from capital gains, interest, and dividends. Internal Revenue Service, Information Services, Martinsburg Computing Center, Master File Service Support Branch.